

# **THE FINANCING AND FINANCIAL RESULTS OF EUROTUNNEL: RETROSPECT AND PROSPECT**

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# **THE FINANCING AND FINANCIAL RESULTS OF EUROTUNNEL: RETROSPECT AND PROSPECT**

## **ABSTRACT**

This paper analyses the financial performance of Eurotunnel over the period of its published accounts following the November 1987 *Offer for Sale* to date, that is a period of 12 years. Approximately the first half of this period (6 and a half years to June 1994) involved construction work and the second half saw the commencement of commercial operations. It is clear that the project did not proceed entirely according to plan. For instance, by 1994 the eventual construction cost was almost double that predicted in 1987. Many of the original traffic and revenue projections proved over optimistic and by the end of 1999 the share price stood at 71p compared with the *Offer for Sale* price 12 years earlier of £3.50. The purpose of this paper is to see what lessons might be drawn to avoid similar mistakes being made on such projects in the future.

# **THE FINANCING AND FINANCIAL RESULTS OF EUROTUNNEL: RETROSPECT AND PROSPECT**

## **I. INTRODUCTION**

Eurotunnel is the operator of the Channel Tunnel which provides a permanent rail link between the UK and France. The main services consist of passenger and freight shuttles as well as passenger trains (Eurostar) and freight trains. Eurotunnel has also widened its operations to encompass retailing (as a competitor to ferry operators), property development and telecommunications.

This paper analyses the financial performance of Eurotunnel over the period of its published accounts following the November 1987 *Offer for Sale* to date, which is a period of 12 years. Approximately the first half of this period (6 and a half years to June 1994) involved construction work and the second half saw the commencement of commercial operations. With the useful benefit of hindsight, it is clear that mistakes were made. For instance, by 1994 it was evident that the eventual construction cost would be almost double that predicted in 1987. Many of the original traffic and revenue projections proved over optimistic. And by the end of 1999 the share price<sup>1</sup> stood at 71p compared with the *Offer for Sale* price 12 years earlier of £3.50. In addition, no dividends had been declared or paid over the 12 year period. The purpose of this paper is to see what lessons might be drawn, particularly for the benefit of shareholders and lenders, to avoid similar mistakes being made on such projects in the future.

### **The Eurotunnel Project**

Plans for a fixed link between the UK and France go back some 200 years. The earliest feasible plan is reckoned to have been devised by Albert Mathieu in 1802.<sup>2</sup> Mathieu envisaged twin bored tunnels between Cap Gris Nez near Calais and Eastwell Bay near Folkestone, surprisingly close in terms of design and location to the present Eurotunnel. During the nineteenth century various schemes were proposed, many spurred on by the development of the railways. However, apart from relatively obvious considerations such as construction cost, one of the stumbling blocks proved to be the issue of national defence and the question of the security of the UK from possible invasion. By the mid 1970s it finally seemed that the issue of national security was no longer a major obstacle and that a collaborative project for a twin bored tunnel might actually go ahead. However, it was finally cancelled by the UK government in 1975, mainly on the grounds of rapidly escalating costs, disruption to the parliamentary timetable caused by two general elections in 1974, and environmental considerations (Holliday, Marcou and Vickerman, 1991, p. 10).

By the 1980s the UK government made it clear that it would only support a fixed link provided public funding was not involved. In April 1985 the French and UK governments invited tenders for the construction and operation of a fixed link. From a shortlist of four consortia, the UK and French governments finally selected the Eurotunnel proposal in early 1986. In July 1987 the French and UK governments ratified

a treaty to regulate the construction and operation of the system. The original concession (since extended) was signed in August 1987 and was for the construction and operation of a Channel Tunnel link until July 2042.

In November 1987 an *Offer for Sale* of 220m units at £3.50 each raised £770m of equity and Excavation began in December 1987. At first, expectations about the commercial viability of the project were generally high. The share price had fallen sharply after the November 1987 *Offer for Sale* which was in fact undersubscribed, partly due to the October 1987 stock market crash. But by March 1988 the share price had almost recovered to the offer price. By the end of 1988 the share price was beginning to rise sharply until in June 1989 it reached a peak of £11.64 which prompted Alastair Morton, at that time Co-Chairman, the following month to warn that the share price was ‘ahead of expectations’<sup>3</sup>. However, this proved to be a temporary period of optimism and by the end of 1989 the share price had suffered a steep fall. Nevertheless it was to remain above the offer price for some time, until late 1994 in fact. Thereafter, the share price entered a period of decline.

The paper proceeds as follows. Section II reviews the period of construction, December 1987 to June 1994. Section III discusses some major events during the first period of commercial operation, July 1994 to December 1999. Section IV compares and contrasts the published prospectus forecasts. Section V analyses the share price movements over the 12 year period 1988 to 1999. Section VI considers the usefulness of the financial statements to the shareholders. Section VII provides a summary and conclusions.

## **II. CONSTRUCTION: DECEMBER 1987 TO JUNE 1994**

Although the November 1987 *Offer for Sale* showed relatively detailed projections of income and expenditure over the life of the Concession, a surprising omission was any phasing of capital expenditure during the construction period. Wearing (1989, p. 12) referred to the absence of projected information on capital expenditure over the construction period and stated that ‘projected information on an annual basis over the construction period would be relevant in assisting readers to monitor the size and implications of any cost overruns, yet this is not given in the *Offer for Sale*’. With the benefit of hindsight, it is interesting to read again the section related to the construction programme in the November 1987 *Offer for Sale*: ‘Certain operations are behind schedule. The view of the Maître d’Oeuvre is that the project is currently about three months late and that the working programme would presently indicate a maximum delay of not more than five months in the completion of the System. However, the Maître d’Oeuvre has indicated that, provided the necessary steps are taken, the time lost can be recovered and the System completed on time’ (*Offer for Sale*, p. 22). Presumably the ‘necessary steps’ would include additional costs such as overtime payments, but it is not clear if these were specifically included in the projected costs as at November 1987.

What is curious in the early years of the project is how the share price managed to rise so sharply. The share price reached a peak of £11.64 in June 1989, yet it is not clear what

favourable information in the meantime could have been responsible for this major shift in market sentiment. Delays in the construction programme carried at least three adverse implications in terms of the eventual cost of the project. Firstly, financing costs would accumulate to a larger extent. Secondly, labour costs would increase. Thirdly, unforeseen problems in the works programme would require costly modifications to equipment. There were also adverse implications in terms of a delayed start to operations and therefore a delay in operational revenues arising. Could the market have predicted at an early stage that all was not well with the progress of construction? Not from the 1988 accounts it appears. The 1988 annual report and accounts which were published in April 1989 gave little indication that anything was amiss following the first year of construction. The section headed 'Review of Business Developments and Prospects', which comprised about one third of a page in the Directors' Report of Eurotunnel plc, provided no hint of delays or problems with the contractors. It contained relatively mundane statements which referred to matters such as the start of the first tunnel boring machine in February 1988 on the French side, and the receipt of the first advances from the banks in early November 1988.

#### FIGURE 1 ABOUT HERE

However, the following year, the 1989 Directors' Report of Eurotunnel plc (published in April 1990) contained a much longer and more informative section. Amongst other things it referred to the fact that in late 1988 relations between Eurotunnel and TML had been 'highly strained' although it did go on to state that working relationships had since improved. Clearly, problems with the progress of the project were appreciated in the company since late 1988, but this information did not apparently reach the market until many months later. Did the management of Eurotunnel have an obligation to make these matters known more widely at an earlier date? Presumably the management hoped that the problems were temporary. Publicising these difficulties would only alarm the market and thereby endanger any future financing needs. On the other hand, an escalating share price carried with it the danger that new investors would be attracted to the project. There is some anecdotal evidence<sup>4</sup> that a number of private investors were attracted to the project in 1988 and early 1989 and subsequently lost considerable sums of money. Several years later they formed a vociferous shareholder association, Adacte, which attempted to take legal action against the directors. Some were undoubtedly naïve in their understanding of the workings of the stock market and in their belief that the French and UK governments would make good any shortfall. The *Financial Times* in 1997 quoted one French shareholder as saying, 'I didn't know what shares were. I thought they were safe like loans. I believed the French and British governments were more or less behind the project'.<sup>5</sup> Nevertheless, in terms of corporate governance, there is perhaps a case for curbing management optimism which might conflict with the interests of stakeholders.

There seems little doubt that the severity of the construction problems facing Eurotunnel were appreciated by the senior management at an early stage. These problems involved construction and commissioning of equipment and are discussed next under the headings of tunnelling, rolling stock and design changes.

## **Tunnelling**

Tunnelling started more slowly than anticipated. The November 1987 *Offer for Sale* declared that 90% of the undersea section was expected to be bored in the ‘most favourable geological layer, consisting of chalk marl, which is virtually impermeable and generally considered ideal for tunnelling’ (Eurotunnel, 1987, p. 20). The only significant area of difficult conditions was thought to be near the French coast where specially designed tunnelling machines would be used. In fact, the ground conditions under the British side proved to be much worse than anticipated<sup>6</sup> with salt water in the rock affecting the performance of the tunnel boring machines. This caused delays and required expensive modifications to the machinery.

In the November 1987 *Offer for Sale* it was stated that ‘The contract provides financial incentives for the Contractor [TML] to complete the tunnels under budget and financial penalties if they are completed over budget or late. It also provides financial penalties if the Contractor completes the System late. This arrangement is designed to encourage the cost-effective completion of the System on time’ (Eurotunnel, 1987, p. 21). It later transpired that TML’s contribution to cost overruns was limited to 6% and a revised agreement was to re-apportion cost overruns between Eurotunnel (70%) and TML (30%).<sup>7</sup>

## **Rolling Stock**

Unexpected increases in the cost of rolling stock occurred. In 1991 the Finance Director of Eurotunnel was quoted as saying ‘In all honesty one now must say that the original rolling stock estimates were put together with insufficient awareness of the complexities of the one-off stock which we would need’.<sup>8</sup> Design changes were imposed by the Inter-Governmental Commission which had been established by the French and UK governments and which was responsible for granting Eurotunnel an operating licence. For example, the Commission required fire doors connecting the shuttle wagons to be widened by 10cm, an apparently small requirement but one which necessitated substantial and costly re-engineering.<sup>9</sup>

## **Design Changes**

No cooling system had been envisaged in the original proposal. It later became apparent that friction caused by the trains as well as heat generated by electrical equipment could raise the temperature inside the tunnel to 50°C. Eventually, an elaborate cooling system was installed, carrying chilled water through several hundred kilometres of piping. The air pressure created by trains travelling at up to 160km per hour meant that all the tunnel components needed to be re-designed to new aerodynamic standards.

## **Directors' Shareholdings**

Movements in directors' shareholdings are sometimes taken as an indication of the future prospects of a company. For instance, for a number of years the *Financial Times* has published on a regular basis details of directors' purchases and sales of shares in their companies. Table 1 shows the number of shares held in Eurotunnel by the ten directors who held office continuously between 31 December 1987 and 31 December 1990. Over this three year period, very little movement occurred in their shareholdings, especially during 1988 and 1999. Only two shareholdings represented more than £10,000 in value at 31 December 1987 and these were held by Malpas (6,010 shares) and Morton (11,500 shares). All directors participated in the November 1990 rights issue except for McMahon and Pennock.

TABLE 1 ABOUT HERE

It would perhaps have appeared inconsistent if the directors did not support their company's call for additional equity in November 1990. At the same time, there was clearly no great enthusiasm to take a larger stake in the future of Eurotunnel than was 'required' by the rights issue. The most appropriate conclusion that can be drawn seems to be that the directors were effectively locked into their shareholdings and unable to sell because of the negative signal that such an action would have conveyed to the stock market. The lack of enthusiasm for further purchases (apart from the November 1990 rights issue) could be interpreted as consistent with a general view by the senior management that the prospects for the foreseeable future were not bright. The Annual Report for 1990 (p. 6) which was published in April 1991 admitted that 'Eurotunnel started 1990 bordering on insolvency'. It is difficult to reconcile such a statement with the extremely high share price in May and June 1989.

## **III. COMMERCIAL OPERATION: JULY 1994 TO DECEMBER 1999**

Eurotunnel opened officially on 6 May 1994, 12 months later than had been predicted in the November 1987 *Offer for Sale*. Eurotunnel took the opportunity of the official opening to make a further rights issue. The May 1994 rights issue was for 324m units @ £2.65 per unit and this largely accounts for the increase in shareholders' funds in that year. For 1994, equity (including share premium) increased by £909m. The main reason for the May 1994 rights issue was the realisation that the financing of the heavy debt burden, taken together with the delay in commercial operations, meant that cash deficits would continue to build up until 1998, by which time it was predicted that operating cash flows would be sufficient to absorb the financing costs. As it turned out, the projected financing costs were relatively accurate. However the projected revenues (and hence projected operating cash flows) were substantially over optimistic. This would mean that the target of cash breakeven in 1998 could not be met.

Despite the delays in commissioning the system and delays in obtaining the necessary systems acceptance certificates, by December 1994 the Eurotunnel system was virtually fully operational. During 1995 it became clear that Eurotunnel's actual revenues were seriously below target. On 14 September 1995 the management of Eurotunnel took the major step of suspending interest payments on its main (junior) debt. Junior debt formed the bulk of its total debt. This operation, referred to as 'standstill' allowed Eurotunnel a breathing space in which the banks agreed not to pursue unpaid interest through legal channels, while Eurotunnel attempted to resolve its debt problems. The period of standstill was to last until 14 December 1997. The Chairmen's letter to the shareholders, dated 19 April 1996, which accompanied the 1995 accounts cited three major factors which were likely to adversely affect future cash flows:

1. Fierce competition, in other words reduced prices charged by ferry operators. Eurotunnel maintained that the ferry companies were able to charge fares below cost due to the continued existence of duty free sales. The special duty free regime which tended to favour the ferry companies rather than Eurotunnel was eventually phased out by the European Union in mid 1999.
2. The failure of the railway companies to develop traffic according to their predictions. The actual passengers and freight carried in 1995 were running at about one third of the levels previously predicted.
3. The increase in operating costs resulting from the complexity and shortcomings of the rolling stock specified and delivered by TML. Eurotunnel also cited the onerous requirements of the governments and the Intergovernmental Commission in terms of operational procedures.

During 1996, Eurotunnel's main preoccupation was with its debt problems and protracted negotiations with the banks. On top of these problems, on 18 November 1996 a serious fire occurred on a freight shuttle. This proved to be a significant setback at a time when commercial operations appeared to be progressing well. Total revenue in 1996 was up by 50% compared to 1995, the first full year of operation. Repair works to the tunnel affected by the fire were not completed until May 1997 and this caused all services to be interrupted. The freight shuttle which was the worst affected was not able to operate for about seven months.

In May 1997 Eurotunnel issued its *Financial Restructuring Proposals*. The main objectives in restructuring the group's debt were to reduce the actual amount of debt and also reduce the cost of servicing the debt. These objectives were achieved in a number of ways in what can only be described as an extremely complex set of financial arrangements (see Appendix A for further details). Part of the junior debt (£1bn) was cancelled by a swap of debt into equity. The immediate effect was to dilute the share of equity of the existing shareholders. A further £1bn of junior debt was converted into 'equity notes' paying a reduced rate of interest. These equity notes would be redeemed in December 2003, and the effect would be a further dilution in the equity (from the standpoint of the original shareholders). £1.2bn of junior debt was converted to a



‘resettable facility’ at a fixed rate of interest. The remainder of the junior debt (£3.86bn) was given a fixed rate of interest to December 2003. Note that the senior debt was not affected by these arrangements.

The restructuring proposals were approved by the shareholders in July 1997. Some members of Adacte, a shareholder action group, were outraged that the banks should be treated so favourably. However, the general consensus at the time appears to have been that there was no other choice and to agree with the management that without the necessary shareholder approval, ‘there is no reasonable prospect of avoiding insolvency procedures in the UK and France. In such circumstances, Unitholders would be unlikely to receive any return on their investment’ (Eurotunnel, 1997).

At the same time as achieving agreement on the financial restructuring, Eurotunnel was able to obtain agreement from the French and UK governments to a substantial extension to the period of the concession, that is from 2052 to 2086. (In December 1993 the French and UK governments had agreed to extend the original expiry date of the concession from 2042 to 2052). One of the effects of this was to allow some fixed assets to be depreciated over a longer period and therefore ‘improve’ annual reported profits by reducing (relatively slightly) annual depreciation charges. The management of Eurotunnel argued that this would help to bring forward the date when a first dividend could be paid. Somewhat perversely, another effect would be to slightly worsen future cash flows, once taxation on company profit became an issue. This effect would occur because taxable profits in France would be increased (depreciation being an allowable expense for taxation purposes) and therefore the tax charge would be incurred somewhat earlier. This issue provides an interesting illustration of the potential conflicts between accruals and cash flow reporting. However, it has to be said that the effects on the overall operations of Eurotunnel could not be considered to be material.

#### **IV. THE EUROTUNNEL PROSPECTUS FORECASTS**

In the early years of the project, the Eurotunnel management and Alastair Morton in particular, were strongly criticised in the media and by some financial analysts for providing over optimistic forecasts of the future revenues and financial prospects of Eurotunnel. Financial analyst, Richard Hannah of UBS, a long term critic of Eurotunnel’s forecasts, was quoted as saying, ‘had the investors originally known the degree of uncertainty in the prospectus, they probably never would have put the money in’<sup>10</sup>. In November 1997 the Lex column in the Financial Times referred to Eurotunnel’s previous forecasts as having proved ‘comically optimistic’<sup>11</sup>.

A summary of some important data contained in the prospectus forecasts is shown in Table 2. Note that the term ‘prospectus is used here to describe the November 1987 *Offer for Sale*, the Rights Issues in November 1990 and May 1994, and the May 1997 Financial Restructuring Proposals. The data in Table 2, which cover these four prospectus events are fairly comparable, since they all include estimates for inflation. The revenue estimates made at November 1987 and November 1990 are almost identical

for first full year of operation (1994) and succeeding years. But it can readily be observed that the projected revenues were substantially over-estimated. Thus the November 1987 revenue estimate for first full year of operation (1994) was £762m which was 151% higher than actual revenue achieved in the first full year (1995) of operation (£304m). In some respects, the Eurotunnel project bears comparison with an earlier Anglo-French project, the Concorde. In both cases capital costs were severely understated and projected revenues were severely overestimated. However, the degree of error was substantially greater in the case of Concorde. Hall (1980, p. 7) refers to a seven fold cost overrun on the Concorde project. Furthermore, only nine aircraft were 'sold', not surprisingly to the British and French state-owned airlines. In comparative terms, Eurotunnel has turned out to be less of a planning disaster than the Concorde project.

#### TABLE 2 ABOUT HERE

The profit before tax figures likewise proved to be substantially overestimated. The higher than anticipated capital costs have resulted in increased depreciation charges and increased interest charges due to the fact that a major part of the capital overspend was financed by debt (rather than equity). Instead of £108m profit before tax in the first full year of operation (as predicted at November 1987), there was an actual loss of £924m in the first full year of operation (1995). It is interesting to note that profit before tax estimates made at November 1990 were substantially below those made three years earlier, whereas the revenue estimates were virtually unchanged. This indicates that the effect on the profit and loss account of the increased capital costs was by 1990 being reflected in the revised projections. Note that the actual profit before tax of £64m and £202m for 1998 and 1999 respectively is largely due to the one-off exceptional gains related to the financial restructuring.

One telling change in the published data between the November 1987 *Offer for Sale* and the November 1990 rights issue concerns the net interest projections. The November 1987 *Offer for Sale* projected that interest paid and interest received would equalise sometime between 2003 and 2013. (On the basis of linear interpolation the precise year would be 2011). However, the November 1990 rights issue projected that interest paid and interest received would equalise sometime between 2033 and 2041. On the basis of linear interpolation the precise year would be 2036. In other words, the effect of increasing the debt was to delay by about 25 years the point at which interest paid and interest received would break even.

Finally, the operating cash flow data confirm the serious outflow of resources. Shortly before 'standstill' in 1995, Eurotunnel's interest charges were running at approximately £2m per day. The apparently encouraging figures of £80m (1996) and £66m (1997) for operating cash flow after interest are largely due to the fact that Eurotunnel was simply withholding the major part of its interest payments. A more accurate picture of Eurotunnel's operations is shown, in this respect, by the losses before tax of £685m and £611m respectively.

In summary, Eurotunnel appears to have grasped at a relatively early stage the adverse effect on future financial performance brought about by the rapidly escalating capital costs. It was not until much later that the management of Eurotunnel appeared to appreciate the extent to which revenues had been overestimated. In fact it is not until May 1997 (by which time the construction was complete and commercial operations had been underway for three years) that revised estimates begin to approach actual revenues and costs.

## **V. EUROTUNNEL SHARE PRICE MOVEMENTS 1988 TO 1999**

Strictly speaking, transactions in the equity of Eurotunnel are based on 'units' of equity where a unit equals one share in Eurotunnel PLC twinned with one share in Eurotunnel SA. However, for the purposes of this paper, reference to the share price of Eurotunnel should be understood to mean the units traded on the London Stock Exchange.

Share price movements over the twelve years 1988 to 1999 are shown in figure 1. The offer price in November 1987 was 350p. The share issue was undersubscribed and within hours the share price fell to 250p. At its peak in June 1989 the share price reached £11.64p. Note that the share prices shown in figure 1 have been adjusted (downwards) mainly to reflect the rights issues in November 1990 and May 1994.

A striking feature of the share price profile is how volatility has generally decreased over time. From being a high risk investment in December 1987 when shares were first traded publicly, Eurotunnel has become a much lower risk 'utility'. The period of greatest volatility was from September 1988 to September 1989. It is quite possible that if the concerns about construction progress had been better appreciated in the market, then the exceptionally high prices recorded in May and June 1989 would not have occurred. On a number of occasions comments have been made to the effect that 'one day someone will make a lot of money out of Eurotunnel'. For those investors fortunate enough to buy ahead of the 1988/89 share price 'bubble' that is already a reality. But if they bought at the peak and were still holding their shares by the end of 1999 they would have lost over 90% of the capital value of their investment, not to mention the opportunity cost of a zero return on their investment. Also badly hit have been the original investors who (assuming they were still holding their shares at the end of 1999) have lost about three quarters of their investment. Once again the actual loss is even greater given the opportunity cost of zero return on investment. In some cases the losses of original investors have been ameliorated by the travel privileges attached to their investment. The extent of these privileges depends on the size of the original investment.

The November 1990 rights issue raised £570m and it is interesting to note that the timing was useful for Eurotunnel because on 30 October contact had been made by a probe in the service tunnel between the French and UK sides and this generated some useful publicity. The May 1994 Rights Issue which raised £816m also followed shortly after the positive publicity surrounding the official opening ceremony on 6 May 1994.

From mid 1994 onwards the share price entered a period of sustained decline. In October 1994 Alastair Morton, ever the optimist, bought 5,000 units at £2.30 and heroically proclaimed 'I'll hold these new shares for at least a year and sell them when the holding shows me 50% per annum growth'<sup>12</sup>. But one year later, in mid October 1995 the shares were standing at just over 80p, having lost about 70% of their value over the preceding year. It is difficult to see how a co-chairman could get it so wrong.

On 14 September 1995 Eurotunnel announced that it was suspending interest payments on its main debt. Over the following week the share price dropped by 29%. Since then and until the end of 1999 the share price has remained relatively stable and has rarely moved outside a band of 50p to 100p. Even the news of the fire which occurred in a freight shuttle on 18 November 1996 caused the share price to fall only by about 10% over the next few days. It is quite probable that the share price during the years 1996 to 1999 was being maintained by the individual shareholders who held travel privileges dating back to the original Offer for Sale in 1987. Travel privileges were also available to new investors holding a minimum of 1,000 shares.

## **VI. THE PUBLISHED FINANCIAL STATEMENTS AND THEIR USEFULNESS TO SHAREHOLDERS**

The stakeholder group which has fared worst over the history of eurotunnel is arguably the shareholder group. Not all shareholders, of course, proved to be worse off. Any shareholders who bought at the time of the original *Offer for Sale* or in early 1988 and then sold in the first half of 1989 would have realised substantial capital gains. But the vast majority of shareholders have undoubtedly incurred substantial losses on their investments.

The main financial statements of Eurotunnel over the period 1988 to 1999 are summarised in Tables 3, 4 and 5. These refer to the 'combined' financial statements of Eurotunnel. Eurotunnel PLC and Eurotunnel SA each publish consolidated accounts which comply respectively with UK and French legislation and accounting standards. These consolidated accounts then go through an additional process of consolidation, but to avoid confusion the end result is referred to as the 'combined accounts'.

The bottom line of the profit and loss account over the period of construction appears constrained to present neither a profit nor a loss. In this context the usefulness of this statement, and in particular the role of capitalising own work, is questionable. In addition the usefulness of providing depreciation in such a project has been questioned before (see Wearing, 1989).

### **TABLE 3 ABOUT HERE**

The financial statements provide a historical record, but it seems clear that the share price reacted to events announced in the media, rather than through the financial statements. If the November 1987 Offer for Sale document had reported the estimated project cost for

each of the years of construction, shareholders might possibly have been in a better position to compare estimated and actual construction costs and thereby appreciate at an earlier date the significant problems faced by Eurotunnel. It is not clear why construction problems and delays known to management in 1988 were not well understood by the market until the second half of 1989. These could have been made known to a wider audience at the time of publication (April 1989) of the 1988 Annual Accounts. That could probably have dampened some of the excessive share price speculation which occurred in the months of May and June 1989. In this respect, the 1988 accounts, to use a generous interpretation, missed an opportunity to warn existing and potential shareholders of some of the problems facing the project.

The anomalies associated with accrual accounting (problems associated with arbitrary allocations) become even more apparent when considering the combined accounts. Thus the combined accounts are an amalgamation of two sets of financial statements prepared on different bases. The calculation of depreciation is a case in point. Reference has already been made above as to how the increase in the concession period led in the French and UK cases to a reduced depreciation charge, but in the French case alone would lead potentially to an increased tax charge. This type of anomaly suggests that a more appropriate focus is the cash events of the project, that is the cash flow report. This is also consistent with Eurotunnel's objective to pay out as dividends 'substantially all of EPLC's and ESA's available distributable profits'<sup>13</sup>.

#### TABLE 4 ABOUT HERE

## VII. SUMMARY AND CONCLUSIONS

There is little doubt that in engineering terms Eurotunnel has been an extremely successful project. Thus the 1999 Annual Report refers to the Channel Tunnel being awarded first prize amongst the top 10 construction projects of the 20<sup>th</sup> century by an international construction panel in the United States<sup>14</sup>. However, it seems that there are a number of lessons which can be drawn from this episode.

Firstly, projected capital costs (on an annual basis) over the construction period 1988 to 1993 were omitted from the original November 1987 *Offer for Sale* document. The history of large capital projects suggests that almost invariably capital costs tend to be underestimated (and revenue costs overestimated). Including more detailed estimates of the phasing of capital expenditure at the outset might have given shareholders an opportunity to monitor more closely the actual expenditures compared to predicted expenditures.

Secondly, Eurotunnel is evolving from a high risk to a low risk project. Somewhat paradoxically, its financing structure (about 80% geared) at the outset was more appropriate for a low risk project. And its eventual financing structure in the future (probably low geared) will be less suitable for its future status as a utility. Equity (given that dividends can be withheld when necessary) is arguably more appropriate when there is considerable uncertainty attached to a project. However, if a larger proportion of equity

had been sought at the outset then perhaps the project would never have started. It should be remembered that the project received no direct government funding, yet a case for some government backing could be argued on the basis of the wider benefits to the economy of an improved transport infrastructure. It is possible that the promoters of Eurotunnel were forced to accept a level of financial gearing higher than they would have preferred and, in order to push the project ahead tended to err on the side of optimism rather than caution in their predictions.

#### TABLE 5 ABOUT HERE

Thirdly, the financial statements appear to provide little new information to users. There are some interesting anomalies in the published accounts. For instance in the first few years of construction the bottom line of the profit and loss account appears contrived to show almost zero profit or loss. It was shown that the increase in the concession period would lead to a somewhat reduced depreciation charge. Although this would have the effect of increasing pretax profit, in the French case it would potentially have a negative impact on cash flow (since depreciation is an allowable deduction for tax purposes). This is an interesting example of the differences between accruals and cash flow accounting and suggests that an informed view is assisted by a cash flow report. It was also noted that care needs to be exercised in interpreting the published cash flows during the period of 'standstill'. The low interest outflows during 1996 and 1997 were due to the fact that Eurotunnel simply withheld payments of interest to most of its creditors while it was in the process of renegotiating its debt with the banks.

Fourthly, as the project has matured, there is an increased understanding of all the risks involved. Share price volatility therefore ought to reduce and this does appear to have happened. Nevertheless it may be the case that, given the past record of overoptimistic forecasts, future expectations of profitability may be substantially discounted. The market may need to see reliable forecasts over a period of time before it fully accepts management estimates of future profitability, cash flow generation and, ultimately, the payment of dividends.

What are the major uncertainties for the years 2000 onwards? The uncertainties mainly relate to growth of traffic. Until the project opened in 1994 a major uncertainty involved initial traffic volumes plus growth rates. Following the commencement of operations the area of uncertainty reduces to growth rates (which are also dependent on the actions of competitors). There is also uncertainty over amount of debt which the banks will want to convert to equity. If the banks convert a relatively large amount, then interest charges will be lower but profit available for dividend will need to be distributed over a larger number of shares (dividend per share will be reduced). Profit or cash flow before interest will not be affected but there will be some uncertainty over the relative returns accruing to lenders versus shareholders. Finally, there are the safety risks associated with operating a tunnel. The Mont Blanc tunnel fire in 1997 and the Austrian ski train fire in 2000 have brought to public attention the dangers associated with tunnel operations. In this respect Eurotunnel is not alone and its ferry competitors are also subject to potentially similar risks.

The November 1987 *Offer for Sale* estimated that dividends would be paid from 1995 onwards. The latest prospectus (May 1997) suggested 2004 for the first payment of dividends, although the 1999 annual accounts appear to have revised this and now suggest some time after 2002 for the first payment of dividends. It seems clear that by the end of 1999 Eurotunnel has progressed to a new stage in its development and the first payment of dividends may prove to be a turning point in investor confidence and its own fortunes.

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**Figure 1**  
**Eurotunnel Share Price 1988 to 1999**



**Table 1**  
**Eurotunnel Directors' Shareholdings\***

	<b>31.12.87</b>	<b>31.12.88</b>	<b>31.12.89</b>	<b>31.12.90</b>
APJ Benard	3,010	3,010	3,010	4,816
DM Child	510	510	500	800
Sir Alistair Frame	10	10	10	16
R Lion	-	-	-	3,600
R Malpas	6,010	6,010	6,010	9,616
Sir Kit McMahon	300	300	600	600
Sir Alastair Morton	11,500	11,500	11,500	18,400
Lord Pennock	1,510	1,510	1,500	1,500
Sir Robert Scholey	1,500	1,500	1,500	2,400
B Thiolon	510	510	510	816

Source: Eurotunnel financial statements 1988 to 1991

\*Covering the three year period 31.12.87 to 31.12.90 during which 10 directors were in office.



**Table 2**

**Eurotunnel Prospectus Forecasts**

	<b>November 1987</b>	<b>November 1990</b>	<b>May 1994</b>	<b>May 1997</b>	<b>Actual</b>
<b>Revenue</b>					
<b>1993</b>	488	393	-	-	-
<b>1994</b>	762	764	137	-	82
<b>1995</b>	835	833	525	-	304
<b>1996</b>	908	904	737	-	483
<b>1997</b>	986	980	829	567	531
<b>1998</b>	1,072	1,070	901	649	666
<b>1999</b>	1,158	1,165	993	654	654
<b>Profit/(Loss) Before Tax</b>					
<b>1993</b>	70	(106)	-	-	-
<b>1994</b>	108	(172)	(382)	-	(387)
<b>1995</b>	199	(106)	(473)	-	(924)
<b>1996</b>	273	(43)	(289)	-	(685)
<b>1997</b>	350	29	(243)	(314)	(611)
<b>1998</b>	422	99	(188)	(254)	64
<b>1999</b>	508	183	(135)	(191)	202
<b>Operating Cash Flow Before Interest</b>					
<b>1993</b>	399	188	-	-	-
<b>1994</b>	610	540	(189)	-	(333)
<b>1995</b>	669	594	235	-	101
<b>1996</b>	729	647	455	-	115
<b>1997</b>	793	721	522	174	201
<b>1998</b>	854	794	582	258	356
<b>1999</b>	935	853	643	312	315
<b>Operating Cash Flow After Interest</b>					
<b>1993</b>	170	(114)	-	-	-
<b>1994</b>	259	(31)	(851)	-	(990)
<b>1995</b>	347	29	(295)	-	(556)
<b>1996</b>	422	91	(108)	-	80
<b>1997</b>	502	177	(70)	10	66
<b>1998</b>	577	255	(28)	111	146
<b>1999</b>	670	332	24	44	63

**Notes:**

1. May 1997 data taken from 'base case' and assuming extension to concession period.
2. November 1987 and November 1990 operating cash flow data calculated using published statements of source and application of funds.

**Table 3**

**Eurotunnel Profit and Loss Accounts 1988 to 1999 (£m)**

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Turnover												
Turnover and other income	1	6	5	11	8	3	31	299	448	456	618	627
Own work capitalised	54	220	506	547	781	846	716					
Deferred expenses and recharges (note 1)					11	46	51	5	35	75	48	27
	55	226	511	558	800	895	798	304	483	531	666	654
Operating costs (excl. depn.)	(82)	(106)	(246)	(169)	(177)	(251)	(402)	(374)	(379)	(341)	(345)	(321)
Depreciation	(14)	(54)	(94)	(92)	(50)	(47)	(146)	(130)	(147)	(126)	(137)	(123)
Operating costs (incl. depn.)	(96)	(160)	(340)	(261)	(227)	(298)	(548)	(504)	(526)	(467)	(482)	(444)
Operating profit/(loss)	(41)	66	171	297	573	597	250	(200)	(43)	64	184	210
Interest (note 2)	41	(65)	(171)	(297)	(575)	(599)	(637)	(724)	(642)	(675)	(399)	(304)
Exceptional item (note 3)											279	296
Net profit/(loss)	0	1	0	0	(2)	(2)	(387)	(924)	(685)	(611)	64	202

Source: Eurotunnel financial statements 1988 to 1999

**Notes:**

1. Deferred expenses and recharges includes payments from insurance companies
2. 'Interest' represents a net figure for financial income and financial charges. These amounts include exchange differences
3. Profit on financial restructuring

Table 4

## Eurotunnel Cash Flows 1988 to 1999 (£m)

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
<b>FINANCE</b>												
Issue of share capital			573	3	3	10	909	56				150
Bank loans	175	887	1,278	1,140	1,604	1,672	795	345	(1)		(8)	(178)
	<u>175</u>	<u>887</u>	<u>1,851</u>	<u>1,143</u>	<u>1,607</u>	<u>1,682</u>	<u>1,704</u>	<u>401</u>	<u>(1)</u>	<u>0</u>	<u>(8)</u>	<u>(28)</u>
<b>INVESTMENT</b>												
Fixed assets	(624)	(1,011)	(1,331)	(1,051)	(1,238)	(843)	(453)	(66)	(39)	(28)	(57)	(58)
	<u>(624)</u>	<u>(1,011)</u>	<u>(1,331)</u>	<u>(1,051)</u>	<u>(1,238)</u>	<u>(843)</u>	<u>(453)</u>	<u>(66)</u>	<u>(39)</u>	<u>(28)</u>	<u>(57)</u>	<u>(58)</u>
<b>OPERATIONS</b>												
Operating cash flow	31	44	165	(139)	(108)	(165)	(333)	101	115	201	356	315
Interest (note 2)	31	(38)	(181)	(328)	(555)	(670)	(657)	(657)	(35)	(135)	(210)	(252)
	<u>62</u>	<u>6</u>	<u>(16)</u>	<u>(467)</u>	<u>(663)</u>	<u>(835)</u>	<u>(990)</u>	<u>(556)</u>	<u>80</u>	<u>66</u>	<u>146</u>	<u>63</u>
<b>INCREASE/(DECREASE) IN CASH</b>	<u>(387)</u>	<u>(118)</u>	<u>504</u>	<u>(375)</u>	<u>(294)</u>	<u>4</u>	<u>261</u>	<u>(221)</u>	<u>40</u>	<u>38</u>	<u>81</u>	<u>(23)</u>

Source: Eurotunnel financial statements 1988 to 1999

## Notes:

1. Cash flow data based on FRS 1, are available only for years 1991 onwards. For 1988, 1989, 1990 the above data has been estimated from the information in the published financial statements of Eurotunnel.
2. For years 1988 to 1990 inclusive, the profit and loss account charge relating to interest payable, income from investments and interest receivable has been taken as a proxy for net interest paid. For years 1991 onwards 'interest' represents 'net cash outflow from return on investments and servicing of finance' as per the published cash flow statements. For 1999, 'interest' includes exceptional expenditure on financial restructuring fees (£5.8m).

**Table 5**

**Eurotunnel Balance Sheets 1988 to 1999 (£m)**

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Fixed assets (note 1)	995	1,953	3,399	4,878	6,757	8,453	9,461	9,400	9,284	9,191	9,108	9,041
Net current assets (note 2)	180	130	584	237	(4)	(14)	301	(35)	9	29	84	51
	<u>1,175</u>	<u>2,083</u>	<u>3,983</u>	<u>5,115</u>	<u>6,753</u>	<u>8,439</u>	<u>9,762</u>	<u>9,365</u>	<u>9,293</u>	<u>9,220</u>	<u>9,192</u>	<u>9,101</u>
Issued share capital	467	467	752	753	755	761	1,318	1,371	1,371	469	195	231
Share premium	556	556	844	846	849	852	1,204	1,207	1,207	1,207	1,401	1,771
Reserves (note 3)	(25)	(26)	(9)	(43)	(363)	(246)	(782)	(2,112)	(2,084)	(1,340)	(534)	121
Shareholders' funds	<u>998</u>	<u>997</u>	<u>1,587</u>	<u>1,556</u>	<u>1,241</u>	<u>1,367</u>	<u>1,740</u>	<u>466</u>	<u>494</u>	<u>336</u>	<u>1,062</u>	<u>2,131</u>
Loans and overdrafts	177	1,086	2,396	3,559	5,512	7,072	8,022	8,899	8,799	8,884	8,130	6,961
	<u>1,175</u>	<u>2,083</u>	<u>3,983</u>	<u>5,115</u>	<u>6,753</u>	<u>8,439</u>	<u>9,762</u>	<u>9,365</u>	<u>9,293</u>	<u>9,220</u>	<u>9,192</u>	<u>9,101</u>

Source: Eurotunnel financial statements 1988 to 1999

**Notes:**

1. Includes tangible fixed assets and financial fixed assets.
2. Current assets less current liabilities; also includes exchange suspense account, deferred income, deferred expenses, prepaid expenses, provisions.
3. Profit and loss account, and exchange adjustment reserve.

## NOTES

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<sup>1</sup> Given that rights issues were made in 1990 and 1994, the capital loss to investors was somewhat smaller than that implied by this comparison, but nevertheless substantial. An investor in the original 1997 Offer for Sale suffered a capital loss of about three quarters by the end of 1999. The only compensation consisted of travel privileges once the project began operations in 1994.

<sup>2</sup> See Holliday, Marcou and Vickerman, 1991, p. 1.

<sup>3</sup> *Sunday Times*, Business Focus p. 3, 16 April 1995.

<sup>4</sup> As reported in *Financial Times*, 9 August 1997

<sup>5</sup> *Financial Times*, 9 August 1997.

<sup>6</sup> See *Financial Times*, 6 May 1994.

<sup>7</sup> See interview with Graham Corbett, Eurotunnel Finance Director, as reported in *Accountancy Age*, January 1991, p. 40.

<sup>8</sup> *Accountancy Age*, January 1991, p. 41.

<sup>9</sup> *Financial Times*, 6 May 1994.

<sup>10</sup> *Sunday Times*, 16 April 1995.

<sup>11</sup> *Financial Times*, 29 November 1997.

<sup>12</sup> Quoted in the *Sunday Times*, 16 April 1995.

<sup>13</sup> Eurotunnel, *Offer for Sale*, November 1987, p. 10.

<sup>14</sup> Eurotunnel, *Annual Report* 1999, p. 1.